G-999/CI-90-40 ORDER AUTHORIZING THE RECOVERY OF TAKE-OR-PAY SETTLEMENT COSTS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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In the Matter of Take-Or-Pay Buy-Out/Buy-Down Costs Incurred By Interstate Natural Gas Pipelines

ISSUE DATE: January 25, 1991

DOCKET NO. G-999/CI-90-40

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PROCEDURAL HISTORY

On February 10, 1989, the Minnesota Department of Public Service (the Department) submitted a report to the Commission entitled "Take or Pay But-Out/Buy-Down Costs: Background and Issues."

On December 29, 1989, the Federal Energy Regulatory Commission (FERC) approved the settlement of Northern Natural Gas Company's (Northern's) rate case, including Northern's treatment of take-or-pay costs.

On January 23, 1990, the Commission opened the current docket (Docket No. G-999/CI-90-40) to address the Commission's responsibilities with respect to these matters.

On January 25, 1990, the Commission gave notice of a meeting to be held February 6, 1990 for the purpose of informal discussion of the issues associated with the pass-through to consumers of take-or-pay costs incurred by interstate natural gas pipelines.

On February 26, 1990, the Commission issued its ORDER FOCUSING DISCUSSION AND ESTABLISHING STRUCTURE AND TIMETABLE OF COMMENT PERIOD.

On January 8, 1991, following receipt of comments from Northern, Minnegasco, Northern States Power Company (NSP), Peoples Natural Gas Company (Peoples) and joint comments from the Minnesota Department of Public Service (the Department) and the Residential Utilities Division of the Office of the Attorney General (RUD-OAG), the Commission met to consider this matter.

FINDINGS AND CONCLUSIONS

I. Background

The natural gas system begins with the producer of natural gas and ends with the retail residential, commercial, or industrial customer. The physical functions of transportation from producers and distribution to customers are performed by interstate pipelines and local distribution companies (LDCs), respectively.

Northern Natural Gas Company (Northern) is the largest interstate pipeline serving Minnesota. As the take-or-pay costs in this proceeding stem from Northern's contracts with producers only, Northern is the only pipeline relevant to this Order. Northern sells gas to and transports gas for LDCs and municipal gas utilities. Northern also transports gas for end-users. Typically in this case, the LDC also provides transportation from Northern to the end-user.

In the early and middle 1970s, interstate pipelines experienced increasing difficulty securing sufficient supplies of natural gas. Gas shortages occurred because the federally-regulated prices of gas to interstate pipelines from producers were far below the unregulated prices that producers could get from intrastate pipelines serving local markets. The low interstate prices also encouraged consumers of interstate pipeline gas to increase their consumption, aggravating the shortages.

Following passage of the Natural Gas Policy Act of 1978, interstate pipelines began acquiring additional gas supplies under terms affected by that act. In order to do so, however, pipelines often signed long-term contracts obligating themselves to pay producers for certain levels of gas even if they were not able to use ("take") the entire amount.[1] Such contracts were called take-or-pay (TOP) contracts.

As deregulation allowed market forces to more strongly affect the gas industry, gas at lower prices became increasingly available and the pipelines' long-term take-or-pay contracts became uneconomic. In addition, orders from the Federal Regulatory Commission (FERC) increased the pipelines' take-or-pay costs. In Order 436, FERC encouraged pipeline customers to seek gas supplies from third-parties. Consequent off-pipeline purchases by the pipelines' customers naturally decreased the customers' demand for pipeline gas thereby increasing the discrepancy

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[1] Although Take-or-Pay clauses typically allowed the pipelines several years to actually physically take the gas after having made take-or-pay payments, it soon became clear that many pipelines would never be able to take the full volumes they were paying for.

between the amount of gas that the pipeline could sell and the amount of gas the pipeline had obligated itself to pay for. Adding to this pressure, FERC Order 380 prohibited pipelines from recovering take-or-pay costs from their customers in minimum bills and relieved pipeline customers of any contractual obligations they may have had to minimum takes from the pipeline.

All of these factors led the pipelines to renegotiate or litigate the long-term take-or-pay contracts and request relief from FERC. In response, FERC's ORDER 500 authorized pipelines to file plans to pass on some take-or-pay costs to their customers, i.e. the costs of "buying out" or "buying down" (settling) their take-or-pay obligations.

On March 31, 1989, Northern filed revised tariff sheets with FERC proposing to recover approximately $353 million of take-or-pay settlement costs in the following manner: 1) collect 25% of such costs, plus interest, through a fixed take-or-pay charge to sales customers, 2) absorb 25% of the costs, and 3) recover the remaining 50%, plus interest, over a five year period through a volumetric surcharge on total throughput.

On December 29, 1989, FERC approved the settlement of Northern's rate case, including a modified plan for the recovery of take-or-pay settlement costs. According to the approved modified plan for recovering take-or-pay settlement costs, Northern's proposed fixed take-or-pay charge, allocated on purchase deficiencies, was eliminated and Northern was authorized to recover its take-or-pay settlement costs solely through a volumetric surcharge on all throughput, i.e. transportation as well as sales, during a five-year surcharge period commencing October 1, 1989. In addition, instead of directly absorbing 25% of the settlement costs, Northern agreed to forego recovery of what it stated was an approximately equivalent amount, the interest on the unamortized balance of the settlement costs over the five-year surcharge period.

Pursuant to this approved settlement, then, Northern began to impose upon its customers (the LDCs) a volumetric surcharge on all throughput, i.e. transportation as well as sales, effective as of October 1, 1989. In turn, Northern's LDC customers in Minnesota (e.g. Minnegasco, Northern States Power, etc.) began to pass through to their own customers Northern's take-or-pay surcharges through the purchased gas adjustment (PGA).

II. The Issues

The Commission must determine whether it is appropriate for Minnesota's LDCs to recover from their customers all the take-or-pay (TOP) charges imposed on them by Northern. In addition, the Commission must determine whether it is appropriate for the LDCs to recover these costs from all their customers through the purchased gas adjustment (PGA).

A. Jurisdiction

The Commission has authority to prevent LDCs from passing through to their customers the entire take-or-pay volumetric surcharge that Northern imposed on the LDCs and may require the LDCs to absorb a portion of those costs. For the Commission to do so would not violate the "filed rate doctrine." In its most recent pronouncement in this area, FERC states

> ...the Commission [FERC] urges state commissions to use the full extent of their authority to equitably allocate between LDCs and their retail customers take-or-pay costs that flow through an interstate pipeline's rates.....
> .....
>
> In the Commission's view, nothing precludes a state commission from requiring an LDC to absorb a share of the costs as the Commission is requiring of interstate pipelines here.

Tennessee Gas Pipeline Co.; Mechanisms for Passthrough of Pipeline Take-Or-Pay Buyout and Buydown Costs, FERC, ORDER (November 1, 1990), Federal Register, Vol. 55, No. 222, Friday, November 16, 1990 at page 47,866.

Because the Commission determines in this Order that it will authorize LDCs to recover from its customers all the TOP costs assessed against them by Northern, the Commission need not specify in this Order the limits, if any, upon the Commission's jurisdiction in this area.

B. Treatment of Northern's TOP Surcharge

Minnesota LDCs have passed through and continue to pass through Northern's entire TOP surcharge to all their customers, firm and interruptible, through the PGA. Because the LDCs pass on the surcharges through the PGA only, the LDCs do not assess a TOP settlement charge against their transportation customers.

Minnesota Industrial Customers (MIC), an association of large industrial customers of Minnesota LDCs, raises several objections to the LDCs' practice.

First, MIC argues that it is unfair to allow LDCs to charge their retail customers for TOP costs because it was Northern and the LDCs, and not the LDCs' customers that entered into the TOP contracts and later incurred the expenses of reforming those contracts. According to MIC, because the LDCs' customers did not <u>cause</u> the TOP expenses, they should not be required to pay them. The Commission finds this analysis unsatisfactory for three reasons. First, the MIC is mistaken: the LDCs were not parties to the TOP contracts. Second, the behavior of the LDC customers, including industrial customers like the MIC members, did contribute to incurring these costs. By seeking out less-expensive supplies, they reduced the pipelines' sales and therefore caused increased TOP liabilities. Third, in determining a fair allocation of TOP costs, the Commission finds it more appropriate to focus on the benefit derived from the TOP expenses. It is clear that the primary beneficiaries of the TOP settlement expenditures are the LDCs' retail customers, who are and have been experiencing reduced gas prices due in large part to the avoidance of the TOP contracts.

Second, MIC asserts that the LDCs' TOP surcharge against their retail customers violates the filed rate doctrine. MIC cites a the recent federal Court of Appeals decision in support of its assertion. Associated Gas Distributors v. FERC, 893 F.2d 349 (D.C.Cir. 1989). However, Associated Gas is not relevant to the instant case. Associated Gas did not find, as MIC suggests, that the TOP recovery mechanism currently used by Northern (a volumetric surcharge upon all current throughput) violates the filed rate doctrine. In Associated Gas, the court was reviewing an entirely different kind of recovery method: the collection of fixed take-or-pay charges based on a purchase deficiency allocation method.[2] In short, the method used by Northern is distinguishable from the method found to violate the fixed rate doctrine in Associated Gas. In Minnesota, LDCs assess TOP charges through the PGA. Such charges, therefore, are collected on a volumetric rather than a fixed basis and are strictly tied to current sales rather than being calculated on the basis of past purchases, i.e those made during the "deficiency period".

Third, MIC argues that retail customers should not be required to bear a part of TOP costs unless the Commission finds that failure to do so would endanger the natural gas supply. MIC asserts that in competitive markets, suppliers are not able to charge customers for costs related to past events. The Commission rejects this blanket proposition and notes that even in the most competitive markets, sellers price their product at least in part to recover the costs incurred to produce the product. In this specific case, the Commission views Northern's TOP settlement costs ("past events" according to MIC) as costs incurred to "produce" or make available its current product, i.e. lower priced non-TOP gas. As such, these costs are clearly attributable to current gas and are properly collectible from the consumers of the current non-TOP gas, i.e. the LDCs' retail

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[2] In the disapproved "purchase deficiency" method, pipeline customers were billed fixed amounts which had been calculated by the pipeline by measuring the customer's purchases in a "deficiency period," the period during which the pipeline incurred the bulk of the take-or-pay liability in question against the customer's purchases in a prior base period. Thus, customers are assigned a portion of the pipeline's take-or-pay costs in proportion the extent their purchases declined during the deficiency period. The purchase deficiency method seeks to bill customers for their share in the "blame" for the pipelines incurring TOP "fixed take" costs.

customers.

Fourth, MIC argues that LDCs should not recover TOP surcharge from transportation customers because transportation customers do not purchase their gas from the LDC and therefore receive no benefit from the lower priced gas that LDCs now have because Northern incurred TOP settlement costs. MIC complains of a situation that does not exist. LDCs do not collect TOP charges from their transportation customers. As indicated above, LDCs collect TOP charges solely through a purchased gas adjustment (PGA) to the price of the gas they sell to their retail customers. Such a collection method, of course, has no application to transportation customers. The only TOP charge that a transportation customer pays is assessed by the pipeline. Fifth, MIC argues that LDCs should not be allowed to impose their TOP costs on interruptible gas customers because interruptible customers place no demand on the LDC. However, the Commission does not view demand as the basis for imposing a TOP surcharge. Instead, the Commission focuses on the gas price benefit derived from TOP settlement costs. Since interruptible customers receive the same benefit from these costs that firm customers receive (lower gas prices), they should share the burden of absorbing those costs.

Sixth, MIC argues that in its Order following remand of the Associated Gas case, FERC has enunciated new principles for pipeline TOP cost recovery plans that have relevance to the Commission's decision in this matter. However, FERC's Order on remand explicitly does not apply to Northern's TOP cost recovery plan.[3] The Order states:

> Some pipelines [such as Northern] have settlements approved by the Commission under which their customers have agreed to the allocation of take-or-pay costs and waived any objections on the basis of the filed rate doctrine.... Such proceedings are not affected by the court's remand or this order. [Bracketed material added.] Federal Register, Vol. 55, No. 222, at page 47,664.

Moreover, FERC clearly indicates that in enunciating principles to guide the formation of TOP cost recovery plans it does not intend to reopen take-or-pay settlements:

> The Commission does not want to reverse or upset the substantial progress to resolving the take-or-pay problem that has been achieved to date. Federal Register, Vol. 55, No. 222, at page 47,666.

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[3] FERC states that the order applies to 13 primary pipelines, none of which is Northern. Also, in Appendix A to the Order, FERC lists Northern among the pipelines that are not subject to the stay imposed by the order.

Finally, in listing general examples of acceptable allocation methods, FERC lists the precise method that Northern is using pursuant to previous FERC approval: volumetric surcharges. FERC states:

> Pipelines may seek to recover the amounts previously recovered through the fixed charge <u>by volumetric surcharges alone</u>. (Emphasis added.) Federal Register, Vol. 55, No. 222, pages 47,666 and 47,667.

In approving pipeline recovery of TOP costs by volumetric surcharges on current sales, FERC was indicating the propriety of viewing the TOP settlement costs as costs of current gas and basing recovery on prospective sales of such gas. Minnesota's LDCs are using a recovery method in keeping with the principles articulated by FERC.

III. Commission Analysis and Action

Parties who have directly benefitted and continue to benefit from the elimination of the take-or-pay contracts should absorb the costs involved in eliminating those contracts. The entire price difference between the higher priced TOP gas and the lower priced new gas has been and continues to be passed on to retail consumers in Minnesota via the PGA. None of the money saved because of the new lower priced gas has been retained by the LDCs. Just as the price reduction realized through eliminating the TOP contracts has been and continues to be passed through to Minnesota retail consumers in full, it is appropriate that the TOP settlement costs attributable to the elimination of those contracts be passed on to Minnesota retail customers.

Stated another way, if Northern had not incurred those costs, it would be unable to offer the less expensive gas that it currently provides. Instead, it would continue to be stuck paying the high prices for fixed volumes of gas under the long-term TOP contracts. The funds that Northern expended to escape TOP contracts so that it could purchase gas at lower prices, therefore, are properly viewed as costs of "producing" the less expensive gas it currently provides. In this light, it is proper that the price of the new gas to the LDCs' retail customers reflect the cost of escaping the TOP contracts.

For the reasons set forth in this Order, the Commission finds that the LDCs' practice of recovering all TOP charges assessed them by Northern through the PGA from all their retail customers is equitable and proper. Indeed, in light of the Commission's analysis, it would be inequitable to require the LDCs to absorb any of the TOP settlement costs. Accordingly, the Commission will authorize the LDCs to continue their current practice in this regard.

ORDER

1. The local distribution companies (LDCs) operating in Minnesota are hereby authorized to continue to recover all the take-or-pay (TOP) settlement costs that are assessed against them by Northern Natural Gas Company. The LDCs are authorized to continue recovering these costs through the purchased gas adjustment to all retail customers.

2. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Richard R. Lancaster
Executive Secretary

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